DEPARTMENT OF STATE REVENUE

02-20170109.LOF

Letter of Findings Number: 02-20170109
Adjusted Gross Income Tax
For Tax Years 2012, 2013, and 2014

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Indiana Company's Canadian rail sales were not subject to the Indiana throwback rule as Indiana Company had sufficient nexus with Canada.

ISSUE

I. Income Tax–Throwback Sales.

Authority: 15 U.S.C. § 381; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-8.1-5-1; IC § 6-3-1-25; 45 IAC 3.1-1-35; 45 IAC 3.1-1-38; 45 IAC 3.1-1-53; 45 IAC 3.1-1-64; *Indiana Dep't. of State Revenue v. Rent-A-Center East, Inc*., 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue,* 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014); *Sherwin-Williams Co. v. Indiana Dep't. of State Revenue*, 673 N.E.2d 849 (Ind. Tax Ct. 1996); *Wisconsin Dep't. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992); *Indiana Dep't of State Revenue v. Kimberly-Clark Corp.*, 416 N.E.2d 1264 (Ind. 1981); United States - Canada Income Tax Convention, U.S.-Ca., Sep. 26, 1980, T.I.A.S 11,087.

Taxpayer maintains that sales to customers in Canada should not be thrown back to Indiana because Taxpayer has nexus in Canada.

STATEMENT OF FACTS

Taxpayer is a "manufacturer, fabricator, and distributor of products and services for the rail, construction, energy and utility markets." As it relates to the rail industry, Taxpayer provides "new and used rail, track work, and accessories . . . [Taxpayer] also designs and produces concrete railroad ties, insulated rail joints, power rail, track fasteners, cover boards and special accessories for mass transit and other rail systems worldwide." Taxpayer operates a rail fabrication and distribution facility in Indiana.

Taxpayer files as a member of a consolidated federal return, but files as a separate filer for Indiana purposes. The Indiana Department of Revenue ("Department") conducted a corporate income tax audit of Taxpayer for tax years 2012, 2013, and 2014. The audit found that "[T]axpayer did not include sales from within Indiana to foreign [locations] where [T]axpayer did not have nexus as throwback sales . . . ." The audit included those foreign sales as throwback sales for each tax year at issue resulting in proposed assessments for all three years.

Taxpayer filed a timely protest of the Department's audit. An administrative hearing was conducted during which Taxpayer explained the basis for its protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Income Tax– Throwback Sales.

DISCUSSION

Pursuant to an audit, the Department included certain foreign sales in Taxpayer's Indiana adjusted gross income. Specifically, the audit determined that Taxpayer did not have nexus with these locations and its income derived from sales to those locations were not subject to tax in those jurisdictions under P.L.86-272. The audit thus applied the Indiana throwback rule, which resulted in additional Indiana income tax for the tax years at issue.

Taxpayer disagrees with the audit results as it pertains to its Canadian sales. Taxpayer asserts that it has nexus with Canada because its Canadian activities "exceed mere solicitation and are protected activities under P.L.86-272." Thus, Taxpayer maintains that the Indiana throwback rule is not applicable.

As a threshold issue, it is the taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *see also Wendt LLP v. Indiana Dep't of State Revenue,* 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). When an agency is charged with enforcing a statute, the jurisprudence defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

For purposes of this discussion, it is important to note that under IC § 6-3-1-25 and 45 IAC 3.1-1-35, "state" is defined as "any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and **any foreign country** or political subdivision thereof." (**Emphasis added**).

"Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. [IC § 6-3-2-1(b).] In cases where a corporation derives business income from sources both within and without Indiana, the 'adjusted gross income derived from sources within the state of Indiana' is determined by an apportionment formula." *Sherwin-Williams Co. v. Indiana Dep't. of State Revenue*, 673 N.E.2d 849, 851 (Ind. Tax Ct. 1996). For all tax years after December 31, 2010, that formula operates by multiplying taxpayer's total business income by a fraction composed of a sales factor. IC § 6-3-2-2(b)(5). The "sales factor" consists of a fraction, "the numerator of which is the total sales of the taxpayer in [Indiana] during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." IC § 6-3-2-2(e). The basic rule for calculating the sales factor is found at IC § 6-3-2-2. IC § 6-3-2-2(e) provides that "[s]ales of tangible personal property are in this state if . . . (2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and . . . (B) the taxpayer is not taxable in the state of the purchaser."

IC § 6-3-2-2(a), in pertinent part, states that Indiana taxpayers are subject to this state's income tax on money earned from doing business within this state:

> (a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
> (1) income from real or tangible personal property located in this state;
> (2) income from doing business in this state;
> (3) income from a trade or profession conducted in this state;
> (4) compensation for labor or services rendered within this state; and
> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property to the extent that the income is apportioned to Indiana under this section or if the income is allocated to Indiana or considered to be derived from sources within Indiana under this section.

However, IC § 6-3-2-2(n) provides that a taxpayer's income is not subject to Indiana's income tax if that income is attributable to doing business in another state in which it is subject to that foreign state's own tax regime:

> (n) For purpose of allocation and apportionment of income under this article, a taxpayer is taxable in another state if:
> (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or
> (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

45 IAC 3.1-1-38 explains the "doing business" in a foreign state principle:

For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:

(1) Maintenance of an office or other place of business in the state
(2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
(3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
(4) Rendering services to customers in the state
(5) Ownership, rental or operation of a business or of property (real or personal) in the state
(6) Acceptance of orders in the state
(7) **Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income**.

As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n) (**Emphasis added**).

45 IAC 3.1-1-64, in relevant part, further illustrates under what conditions a taxpayer is "doing business" and is therefore taxable in another state:

A corporation is "taxable in another state" under the Act when such state has jurisdiction to subject it to a net income tax. This test applies if the taxpayer's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and statutes of the United States. **Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provision of Public Law 86-272, 15 U.S.C.A. §381-385**. In the case of any "State," as defined in IC 6-3-1-25, other than a state of the United States or political subdivision of such state, the determination of whether such "state" has jurisdiction to subject the taxpayer to a net income tax shall be made by application of the jurisdictional standards applicable to that state of the United States. If jurisdiction to tax is otherwise present, such "state" is not considered as being without jurisdiction to tax by reason of the provisions of a treaty between that state and the United States.

Example:

Corporation X is actively engaged in manufacturing farm equipment in State A and foreign country B. Both State A and foreign country B impose a net income tax but foreign country B exempts corporations engaged in manufacturing farm equipment. Corporation X is subject to the jurisdiction of State A and foreign country B.

Taxpayers are not subject to throwback on sales into states in which they are taxable under this regulation [45 IAC 3.1-1-64]. See Regulation 6-3-2-2(e)(040) [45 IAC 3.1-1-53].

(**Emphasis added**).

45 IAC 3.1-1-53 describes the "throw back" principle:

Gross receipts from the sales of tangible personal property (except sales to the United States Government-See Regulation 6-3-2-2(e)(050) [45 IAC 3.1-1-54] are in this state: (a) if the property is delivered or shipped to a purchaser within this state regardless of the F.O.B. point or other conditions of sales; or (b) if the property is shipped from an office, store, factory, or other place of storage in this state, and the taxpayer is not taxable in the state of the purchaser. See Regulation 6-3-2-2(n)(010) [45 IAC 3.1-1-64].

Examples:
. . .
(5) **If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. Such sale is termed a "Throwback" sale**. Example: The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in Indiana. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in Indiana for approval and are filled by shipment from the inventory in Indiana. Since the taxpayer is immune under P.L.86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to Indiana, the state from which the merchandise was shipped.

. . .
(**Emphasis added**).

The first issue at hand is whether Taxpayer's Canadian activities brought Taxpayer within the purview of the Canadian tax regime. 15 U.S.C. § 381(a) (Public Law 86-272) establishes the minimum standards under which Indiana or any foreign state may permissibly impose tax. In relevant part, the law provides as follows:

> No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
>
> (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
>
> (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

15 U.S.C. § 381(c) explains under which conditions a company is *not* conducting business in another state:

> For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

Accordingly, in every transaction, at least one state has the authority to impose tax on income derived from the sale of tangible personal property. Public Law 86-282 prohibits states from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within that state is the solicitation of sales. A state may not impose an income tax on income derived from business activities within that state unless those activities exceed the "mere solicitation" of sales.

The court in *Indiana Dep't of State Revenue v. Kimberly-Clark Corp.*, 416 N.E.2d 1264 (Ind. 1981), found that the nonresident taxpayer did not exceed solicitation of orders for sales in Indiana because it only employed several salesmen who lived in Indiana to perform activities such as, checking inventories, checking shelf facings, and explaining products. *Id.* at 1266. The Kimberly-Clark court stated that "each case must be judged upon its own merits, with particular emphasis placed upon the totality of a corporation's activities within a state." *Id*. at 1268. The Kimberly-Clark court held that solicitation of orders for sales includes "sundry activities so long as those activities (are) closely related to the eventual sale of a product." *Id*. (Internal citation omitted). The Kimberly-Clark court concluded that the taxpayer's activities in Indiana were "inextricably related to solicitation" or as "acts of courtesy," and, therefore, the taxpayer was not taxable in Indiana. *Id*.

The U.S. Supreme Court refined the "mere solicitation" standard in *Wisconsin Dep't. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992). In *Wrigley*, the taxpayer, a manufacturer of chewing gum, claimed that P.L. 86-272 prohibits Wisconsin from taxing its income because (1) it did not have any office (or real estate) in Wisconsin and (2) its business activities in Wisconsin were within the scope of solicitation of orders and were *de minimis*. *Id*. at 235. The Court disagreed and, in relevant part, stated:

> We proceed, therefore, to describe what we think the proper standard to be. Once it is acknowledged, as we have concluded it must be, that "solicitation of orders" covers more than what is strictly *essential* to making requests for purchases, the next (and perhaps the only other) clear line is the one between those activities that are *entirely ancillary* to requests for purchases–those that serve no independent business function apart from their connection to the soliciting of orders–and those activities that the company would have reason to engage in anyway but chooses to allocate to its in-state sales force. Providing a car and a stock of free samples to salesmen is part of the "solicitation of orders," because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company's products is not part of the "solicitation of orders," since there is good reason to get that done whether or not the company has a sales force. Repair and servicing may help to *increase* purchases; but it is not ancillary to *requesting*

> *purchases*, and cannot be converted into "solicitation" by merely being assigned to salesmen.
>
> *Id*. at 228-29 (*Emphasis in original*) (Internal citation omitted).

The Court further explained:

> By contrast, Wrigley's in-state recruitment, training, and evaluation of sales representatives and its use of hotels and homes for sales-related meetings served no purpose apart from their role in facilitating solicitation. The same must be said of the instances in which Wrigley's regional sales manager contacted the Chicago office about "rather nasty" credit disputes involving important accounts in order to "get the account and [Wrigley's] credit department communicating." It hardly appears likely that this mediating function between the customer and the central office would have been performed by some other employee – some company ombudsman, so to speak – if the on-location sales staff did not exist. The purpose of the activity, in other words, was to ingratiate the salesman with the customer, thereby facilitating requests for purchases.
>
> Finally, Wrigley argues that the various nonimmune activities, considered singly or together, are *de minimis*. In particular, Wrigley emphasizes that the gum sales through "agency stock checks" accounted for only 0.00007 [percent] of Wrigley's annual Wisconsin sales, and in absolute terms amounted to only several hundred dollars a year. We need not decide whether any of the nonimmune activities was *de minimis* in isolation; taken together, they clearly are not. Wrigley's sales representatives exchanged stale gum, as a matter of regular company policy, on a continuing basis, and Wrigley maintained a stock of gum worth several thousand dollars in the State for this purpose, as well as for the less frequently pursued (but equally unprotected) purpose of selling gum through "agency stock checks." Although the relative magnitude of these activities was not large compared to Wrigley's other operations in Wisconsin, we have little difficulty concluding that they constituted a nontrivial additional connection with the State. Because Wrigley's business activities within Wisconsin were not limited to those specified in § 381, the prohibition on net-income taxation contained in that provision was inapplicable.

Id. at 234-5.

Ruling in favor of Wisconsin, the court thus held that the taxpayer in *Wrigley* was subject to Wisconsin's net income tax because its business activities in Wisconsin exceeded P.L. 86-272's protection. *Id.* at 235. Thus, following the *Wrigley* decision, an Indiana company's income derived from its sales to other states is thrown back to Indiana for income tax purposes when the Indiana company's business activities in those states are protected and are not taxable pursuant to P.L. 86-272.

In the instant case, Taxpayer manufactures, fabricates and distributes products and services for the rail, construction, energy and utility markets. In its protest and during the administrative hearing, Taxpayer gave a detailed account of its rail activity in Canada. Taxpayer supplies standard lengths of rail as well as continuous welded rail ("CWR") in 1,600 foot lengths. "Due to the size and nature of [CWR], [Taxpayer] owns a fleet of modified flat-bed train cars used to transport the CWR to customer job sites. [Taxpayer] also owns a specialized unloading car, which is used at the jobsite to unload the [CWR] from the train." However, "[Taxpayer] does not own any locomotives, so a railroad . . . must be engaged by [Taxpayer] to haul its weld train to a customer's job site."

When CWR is delivered to a customer's job site, a [Taxpayer] "employee will travel to the destination to supervise the process and operate the unloader car, and work in unison with the rest of the crew to pull the rail off the weld train as a locomotive pulls the weld train in the opposing direction." Customer typically provide the locomotive, but if not, Taxpayer will rent one. Customers also typically provide its own crew, but if not, Taxpayer will send its own. Unloading CWR "takes roughly [three] days without any delays or other constraints." Taxpayer does not install any of the rail.

During the years at issue, "[T]axpayer had no property, rented locations or payroll within Canada." Taxpayer had between one and four CWR projects per year during the audit period. With each project, Taxpayer provided between one and three employees to assist customer's crew with unloading the rail. The audit applied the Indiana throwback rule to Taxpayer's Canadian sales as "Taxpayer's activity consisted solely of delivering the product[, and] Public law 96-272 does not site delivery as an element that exceeds mere solicitation and establishes nexus." Taxpayer believes that its activities exceeded mere solicitation and constituted "doing business" in Canada.

The Department agrees with Taxpayer's argument. Unlike the Taxpayer in *Kimberly-Clark*, Taxpayer's activities

were not "inextricably related to solicitation" and were more than "acts of courtesy." Taxpayer's activities took place *because* of a sale, however, like the activities in *Wrigley*, the services may help increase purchases, but were not ancillary to requesting purchases. Indeed, Taxpayer's employees were not sales people and were not engaging in solicitation while in Canada. Further, as pointed out by Taxpayer in its protest, Taxpayer's use of its unloader car and rental of locomotives falls under the definition of "doing business" in a state under 45 IAC 3.1-1-38(5). Additionally, the unloading services provided to customers in Canada qualify as "doing business" in a state under 45 IAC 3.1-1-38(4).

As the court stated in *Kimberly-Clark*, "each case must be judged upon its own merits, with particular emphasis placed upon the totality of a corporation's activities within a state." Though Taxpayer's activities within the rail market are at issue here, Taxpayer notes that it "sells other product lines to Canadian customers . . . ." These sales may require Taxpayer to "collect and remit Canada's Goods and Services Tax . . . or Harmonized Sales Tax . . . ." Taxpayer's non-rail sales activities and sales tax filings in Canada tip Taxpayer's activities beyond the "mere solicitation" test. When viewing Taxpayer's activities as a whole, the Department believes that Taxpayer has sufficient nexus with Canada to eliminate those sales from Indiana throwback sales.

FINDINGS

Taxpayer's protest is sustained.

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